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FENNEMORE CRAIG
A Professional Corporation
Norman D. James (No. 006901)
Jay L. Shapiro (No. 014650)
3003 North Central Avenue
Suite 2600
Phoenix, Arizona 85012-2913
Telephone: (602) 916-5000

Attorneys for Arizona-American
Water Company

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF ARIZONA-AMERICAN WATER
COMPANY, AN ARIZONA
CORPORATION, FOR AUTHORITY TO
ISSUE SHORT-TERM AND LONG-TERM
DEBT INSTRUMENTS IN CONNECTION
WITH FINANCING THE ACQUISITION OF
THE WATER AND WASTEWATER
UTILITY PLANT AND ASSETS OF
CITIZENS COMMUNICATIONS, INC.

Docket No. W-01303A-00-0929

NOTICE OF FILING REPORT

Arizona-American Water Company hereby files its report analyzing the savings resulting from having American Water Capital Corp. provide financing in connection with the acquisition of the water and wastewater systems formerly owned by Citizens Communications Company, as required by Decision No. 64002 (Aug. 30, 2001).

DATED this 13th day of January, 2003.

FENNEMORE CRAIG

By

Norman D. James
Jay L. Shapiro
3003 North Central Avenue
Suite 2600
Phoenix, AZ 85012
Attorneys for Applicant

1 An original and 13 copies of the
2 foregoing were delivered this
3 13th day of January, 2003, to:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington
6 Phoenix, AZ 85007

5 A copy of the foregoing
6 was delivered this 13th day of
7 January, 2003, to:

7 Patrick Williams
8 Compliance Supervisor
9 Utilities Division
10 Arizona Corporation Commission
11 1200 West Washington
12 Phoenix, AZ 85007

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12 By: Mary L House
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**ARIZONA-AMERICAN FINANCING COSTS RESULTING FROM HAVING
AMERICAN WATER CAPITAL CORPORATION PROVIDE FINANCING
COMPARED TO PROCUREMENT OF FINANCING FROM A NON-AFFILIATE**

**Dr. Thomas M. Zepp
Utility Resources, Inc.
Salem, Oregon**

January 10, 2003

**Prepared For
Arizona-American Water Company**

**Arizona-American Financing Costs Resulting from Having
American Water Capital Corporation Provide Financing
Compared to Procurement of Financing from a Non-Affiliate**

Dr. Thomas M. Zepp
Utility Resources, Inc.
Salem, Oregon

January 10, 2003

Debt financing for the purchase of the water and sewer systems of Citizens Communications by Arizona-American Water Company ("Arizona-American") was provided by American Water Capital Corp. ("Capital Corp"), a subsidiary of American Water Works Company and an affiliate of Arizona-American. In Decision No. 64002, the Arizona Corporation Commission authorized Arizona-American to borrow funds for this acquisition from Capital Corp., but required Arizona-American to perform an analysis showing that savings resulted from having Capital Corp. provide financing, as compared to Arizona-American procuring financing from a non-affiliate. Decision 64002 (Aug. 30, 2001) at 9 (Finding of Fact 19) and 11.

For the reasons explained below, such savings are being provided by being able to provide financing with a more leveraged capital structure with lower costs of debt than Arizona-American would have if it had to borrow from a non-affiliate. In addition, Arizona-American avoided the costs associated with procuring financing from a non-affiliated lender. While issuance costs vary, these costs often amount to 2% to 3% of the issuance, and are therefore a relatively significant cost to the utility in a transaction of this magnitude.

Summary of the Debt Financing. Arizona-American's purchase of Citizens Communications' water and sewer systems closed on January 15, 2002. The total purchase

price was \$277,471,277, and was funded by a mixture of debt and equity (including the assumption of certain Industrial Development Revenue Bonds issued to Citizens). See Schedules D-1 and D-2, attached to the Supplement to Direct Testimony of David P. Stephenson, Docket No. WS-01303A-02-0870, filed January 3, 2003. Capital Corp. provided long-term debt in the amount of \$154,948,119, at an interest rate of 4.92%. This debt is unsecured, and no restrictions or other requirements were imposed to secure repayment. By comparison, as of late 2001 (i.e., the time period during which acquisition financing would have been arranged), the interest rates on utility bonds rated A and Baa/BBB were 7.51% and 7.82%, respectively. Value Line Selection & Opinion, November 30, 2001. The debt financing provided by Capital Corp. constituted approximately 56% of the total purchase price, and when combined with the Citizens bonds, resulted in a capital structure consisting of approximately 40% common equity and 60% debt.

Savings Related to Capital Structure. A small equity ratio (high debt ratio) benefits Arizona-American's customers by allowing rates to be lower for two reasons. First, the after-tax cost of equity is more expensive than the cost of debt. There may be differences of opinion about how much the cost of equity exceeds the cost of debt, but no credible analyst would argue the after-tax cost of equity is less the cost of debt. Second, interest expenses provide a tax benefit because interest expenses reduce taxable income. By contrast, customer rates must be increased to recover not only the after-tax returns required by equity owners, but also the income taxes that must be paid when that income is earned. Regulators routinely require the tax benefits of debt to be flowed through to ratepayers.

Arizona-American is able to adopt a more leveraged capital structure because it has access to debt at a reasonable cost provided by Capital Corp. If Arizona-American had to

obtain financing from a non-affiliated source, it would have a difficult time getting any party interested in providing that financing. Typically, water utilities the size of Arizona-American obtain debt financing from insurance companies. The next largest water company in Arizona, Arizona Water, had a difficult time getting anyone interested in buying its Series K bond issue at a reasonable cost. See Corrected Rebuttal Testimony of Ralph Kennedy, Docket No. W-01445A-00-0962, dated August 7, 2001, at 45-49. Potential non-affiliated purchasers of Arizona-American debt would be the same types of institutions contacted by Arizona Water.

But even if Arizona-American could find a non-affiliated entity that would purchase its debt, it would have to increase its equity ratio by a substantial amount to satisfy such a purchaser. Table 1 provides a list of publicly-traded water utilities listed by C. A. Turner Reports in 2001 that provided service to more than 70,000 customers. (Arizona-American provides service to about 120,000 customers.) The average equity ratio for the publicly traded water utilities is 51%. Arizona Water, like Arizona-American, is not publicly-traded. Arizona Water had an equity ratio in excess of 65% and still had difficulty getting anyone interested in its debt issue at a reasonable cost. Both the 51% average equity ratio and the 65+% equity ratio are substantially higher than the 40% to 45% equity ratio Arizona-American intends to maintain following the completion of the Citizens' acquisition. Decision 64002 at 3. If Arizona-American had to obtain financing from a non-affiliate, its customers would lose the benefits of the leveraged capital structure it is able to adopt when it has the financial strength of the Capital Corp. providing proceeds from debt issues rated A- by S&P.

Savings Related to Debt Costs. Arizona-American has access to the proceeds of Capital Corp debt rated A- by S&P. See Decision 64002 at 3. When compared to potential costs of debt available to Arizona-American from non-affiliates, access to

proceeds from Capital Corp. debt will also reduce Arizona-American's cost of debt. Arizona-American, on a stand-alone basis, could not expect to obtain debt from a non-affiliate at a cost substantially different than other water utilities have been able to obtain. Debt issues recently placed by two water utilities with potential purchasers that would be the likely non-affiliated sources available to Arizona-American show Arizona-American's debt cost would be higher if placed with a non-affiliate. First, in February 2001, Arizona Water fixed the rate on its Series K debt issue at 8.04%. At that time, the cost of Baa/BBB-rated utility bonds were reported to have an interest rate of 7.93% and A-rated utility bonds were reported to have an interest rate of 7.67%. Value Line Selection & Opinion, February 16, 2001.

A second comparison can be made by referring to Park Water Company's March 2000 debt issue. Park Water provides water utility service in Montana and California and, like Arizona-American, is not publicly-traded. In March 2000, its consolidated equity ratio was in excess of 65% but the cost to place its March 2000 debt issue was 8.82% when the cost of A-rated bonds was 8.28%. Even with larger equity ratios than Arizona-American, Arizona Water and Park Water had costs of debt that were 37 to 54 basis points higher than Arizona-American could expect to receive by having access to proceeds of A-rated debt provided by Capital Corp.

Schedule Illustrating Estimated Cost Savings. It is difficult to quantify the amount of savings resulting from having Capital Corp. provide debt financing in connection with the acquisition of the Citizens water and sewer systems. To illustrate one possible scenario, David Stephenson of American Water Works Service Company has prepared a revised version of Schedule D, attached to the Supplement to Direct Testimony of David P. Stephenson, filed January 3, 2003, in Docket No. WS-01303A-02-0870, that compares the capital structure resulting from the Citizens acquisition to a hypothetical

capital structure. In the hypothetical capital structure, the amount of common equity has been increased to 51%, which is equal to the average equity ratio of the water utilities shown on Table 1. As explained above, it is unlikely that Arizona-American could maintain a common equity ratio of 40% to 45% if debt financing were provided by a non-affiliated lender. In addition, the cost of debt has been increased to 8.04%, which is equal to the interest rate required of Arizona Water in connection with its Series K debt issue, discussed above. As shown on the attached schedule, the composite cost of capital increases under this scenario from 7.65% to 9.78%, while the pre-tax cost would increase from 10.65% to 13.60%. Again, this is a hypothetical scenario; however, it serves to illustrate that substantial savings likely resulted from having Capital Corp. provide financing, as opposed to procuring financing from a non-affiliate.

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Table 1: Comparison of Arizona-American to Water
Utilities Followed by C. A. Turner Utility Reports

	Number of Customers	S&P Bond Rating	Common Equity Ratio
American States	256,000	A+	52%
California Water Service	432,000	AA-	51%
Connecticut Water Service	70,000	no	50%
Middlesex Water	75,000	A+	45%
Philadelphia Suburban	553,000	AA-	47%
SJW Corporation	220,000	no	61%
Southwest Water	88,000	no	50%
Average	242,000	--	51%
Arizona-American	120,000	no	40% to 45%

Sources: C.A. Turner Utility Reports, 2001 Financial Statistics of Public
Utilities, AUS Consultants, Moorestown, New Jersey. Bond
ratings as reported in December 2001 C. A. Turner Utility Reports.

SCH: SCH#D-1

ARIZONA-AMERICAN WATER COMPANY
SUMMARY COST OF CAPITAL

Page 1 of 1
01/10/03

Line No.	INVESTED CAPITAL	At 01/15/02					Pre-Tax Cost
		Amount	%	Cost Rate(e)	Composite Cost	Tax Gross-Up	
1.	Long-Term Debt	\$ 154,948,119	56.04%	4.92%	2.76%	1.00	2.76%
2.	Long-Term Debt	10,635,000	3.85%	7.30%	0.28%	1.00	0.28%
3.	Long-Term Debt	0	0.00%	0.00%	0.00%	1.00	0.00%
4.	Common Equity	110,888,158	40.11%	11.50%	4.61%	1.65	7.61%
5.	Short-Term Debt	0	0.00%	0.00%	0.00%	1.00	0.00%
6.	Deferrals	0	0.00%	0.00%	0.00%	1.00	0.00%
		<u>\$ 276,471,277</u>	<u>100.00%</u>		<u>7.65%</u>		<u>10.65%</u>

SCH: SCH#D-1

ARIZONA-AMERICAN WATER COMPANY
SUMMARY COST OF CAPITAL

Page 1 of 1
01/10/03

Line No.	INVESTED CAPITAL	At 01/15/02					Pre-Tax Cost
		Amount	%	Cost Rate(e)	Composite Cost	Tax Gross-Up	
1.	Long-Term Debt	\$ 124,835,926	45.15%	8.04%	3.63%	1.00	3.63%
2.	Long-Term Debt	10,635,000	3.85%	7.30%	0.28%	1.00	0.28%
3.	Long-Term Debt	0	0.00%	0.00%	0.00%	1.00	0.00%
4.	Common Equity	141,000,351	51.00%	11.50%	5.87%	1.65	9.69%
5.	Short-Term Debt	0	0.00%	0.00%	0.00%	1.00	0.00%
6.	Deferrals	0	0.00%	0.00%	0.00%	1.00	0.00%
		<u>\$ 276,471,277</u>	<u>100.00%</u>		<u>9.78%</u>		<u>13.60%</u>

REVENUE SAVING CALCULATION

	Rate Base Per Filing	Return Differential	Rev. Req. Difference
Fair Value Rate Base	\$149,067,569	2.95%	\$4,396,003